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Nos. ~~554 and 575~~

In the Supreme Court of the United States

OCTOBER TERM, 1927

ELIZABETH C. TAFT, PETITIONER

v.

FRANK K. BOWERS, COLLECTOR OF INTERNAL REVENUE FOR THE SECOND DISTRICT OF NEW YORK

GILBERT C. GREENWAY, JR., PETITIONER

v.

FRANK K. BOWERS, COLLECTOR OF INTERNAL REVENUE FOR THE SECOND DISTRICT OF NEW YORK

ON WRITS OF CERTIORARI TO THE UNITED STATES CIRCUIT COURT OF APPEALS FOR THE SECOND CIRCUIT

BRIEF FOR THE RESPONDENT

U.S. GOVERNMENT PRINTING OFFICE: 1928

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ON WRITS OF CERTIORARI TO THE UNITED STATES CIRCUIT COURT OF APPEALS FOR THE SECOND CIRCUIT

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OPINIONS BELOW

The District Court for the Southern District of New York disposed of both of these cases in one opinion (*Taft case*, R. 8; *Greenway case*, R. 12–13), which is reported in 15 F. (2d) 890. The Circuit Court of Appeals for the Second Circuit also de-

cided the cases together, each of the three judges, however, writing a separate opinion, one dissenting. (*Taft case,* R. 14–23; *Greenway case,* R. 19–28.) These opinions are reported in 20 F. (2d) 561.

JURISDICTION

The judgments sought to be reviewed were entered in each case July 13, 1927. (*Taft case,* R. 24; *Greenway case,* R. 28.) Petition for certiorari was filed in the *Taft case* September 26, 1927, and in the *Greenway case* October 3, 1927, and were granted pursuant to Section 240 (a) of the Judicial Code, as amended by the Act of February 13, 1925.

QUESTION PRESENTED

Both cases present the single question whether or not Section 202 (a) (2) of the Revenue Act of 1921, which requires the donee upon the sale of property acquired by gift after December 31, 1920, to use the cost of the property to the donor as the basis for computing profit, is constitutional in so far as it taxes as income to the donee the appreciation in the value of the gift prior to its acquisition by the donee.

CONSTITUTIONAL AMENDMENT AND STATUTES INVOLVED

The Sixteenth Amendment to the Constitution of the United States provides:

> The Congress shall have power to lay and collect taxes on incomes, from whatever source derived, without apportionment among the several States, and without regard to any census or enumeration.

Section 202 (a) (2) of the Revenue Act of 1921, c. 136, 42 Stat. 227, 229, provides:

> SEC. 202. (a) That the basis for ascertaining the gain derived or loss sustained from a sale or other disposition of property, real, personal, or mixed, acquired after February 28, 1913, shall be the cost of such property; except that—
>
> * * * * *
>
> (2) In the case of such property, acquired by gift after December 31, 1920, the basis shall be the same as that which it would have in the hands of the donor or the last preceding owner by whom it was not acquired by gift. If the facts necessary to determine such basis are unknown to the donee, the Commissioner shall, if possible, obtain such facts from such donor or last preceding owner, or any other person cognizant thereof. If the Commissioner finds it impossible to obtain such facts, the basis shall be the value of such property as found by the Commissioner as of the date or approximate date at which, according to the best information the Commissioner is able to obtain, such property was acquired by such donor or last preceding owner. * * *.

Section 213 of the same Act defines "income" as follows (p. 237):

> SEC. 213. That for the purposes of this title (except as otherwise provided in section 233) the term "gross income"—
>
> (a) Includes gains, profits, and income derived from salaries, wages, or compensa-

tion for personal service (including in the case of the President of the United States, the judges of the Supreme and inferior courts of the United States, and all other officers and employees, whether elected or appointed, of the United States, Alaska, Hawaii, or any political subdivision thereof, or the District of Columbia, the compensation received as such), of whatever kind and in whatever form paid, or from professions, vocations, trades, businesses, commerce, or sales, or dealings in property, whether real or personal, growing out of the ownership or use of or interest in such property; also from interest, rent, dividends, securities, or the transaction of any business carried on for gain or profit, or gains or profits and income derived from any source whatever. The amount of all such items (except as provided in subdivision (e) of section 201) shall be included in the gross income for the taxable year in which received by the taxpayer, unless, under methods of accounting permitted under subdivision (b) of section 212, any such amounts are to be properly accounted for as of a different period; but

(b) Does not include the following items, which shall be exempt from taxation under this title:

* * * * *

(3) The value of property acquired by gift, bequest, devise, or descent (but the income from such property shall be included in gross income); * * *.

STATEMENT

In the *Taft case* petitioner, prior to April, 1922, and after December 31, 1920, received as gifts from her father 150 shares of common stock of the Nash Motors Company. (R. 3.) These shares were originally obtained by petitioner's father as a bonus in connection with the purchase by him of preferred stock of said company, and the amended complaint alleges that the common stock received by him at that time had no market price or value. (R. 4.) As the result of a stock dividend declared in February, 1923, petitioner became the record owner of 750 shares of common and 450 shares of preferred stock in the Nash Motors Company. (R. 3.) Some time later, in 1923, petitioner sold 200 shares of common and 130 shares of preferred stock for $34,345.30. (R. 3–4.) The market value of the original 150 shares of common stock at the time the gifts were made was $42,350. By a method of allocation, as to which there is no dispute, it is found that the shares which were sold in 1923 for $34,345.30 were worth $11,708.80 when received by petitioner from her father. (R. 4.) In making her return for 1923, petitioner, pursuant to Section 202 (a) (2), *supra,* included the entire proceeds of the sale of the stock as income and paid the tax thereon under protest. (R. 4.) A claim for the refund of $2,040.09, representing the amount of the tax in dispute, was duly filed and after six months this action was brought for recovery (R. 5), upon the ground that only the

difference between the value of the stock when she acquired it and the price at which she sold it was taxable income within the meaning of the Sixteenth Amendment to the Constitution.

In the *Greenway case* petitioner received as gifts from his brother 10,000 shares of the capital stock of the Ahumada Lead Company, 5,000 shares on or about March 29, 1921, and 5,000 additional shares on or about March 1, 1922. These shares were originally purchased by petitioner's brother for $10,000. The market value of said shares at the time the gifts were made was $30,000. Subsequently, on or about August 1, 1922, petitioner sold the said 10,000 shares of stock for $52,500. (R. 3.) In making his return for 1922, petitioner, pursuant to Section 202 (a) (2), *supra,* included as income the sum of $42,500, which represented the difference between the cost of said shares to his brother and the price for which petitioner sold them, and paid the tax thereon under protest. (R. 4.) Upon the rejection by the Commissioner of Internal Revenue of a claim for refund of $4,441.61, representing the amount of the tax in dispute (R. 6), this action was brought for recovery, petitioner contending that only the difference between the value of the stock when petitioner acquired it and the price at which he sold it was taxable under the Constitution. (R. 5.)

The District Court for the Southern District of New York sustained the position of petitioners,

holding that no part of the value of a *bona fide* gift as of the date of delivery constitutes taxable income in the hands of the donee within the meaning of the Sixteenth Amendment, and that a tax upon a donee measured by the increase in value from the time the donor originally acquired it until the time the donee sold it was a direct and unconstitutional tax on the gift itself. (*Taft case,* R. 8; *Greenway case,* R. 12.)

Upon writs of error the judgments of the District Court were reversed by the Circuit Court of Appeals for the Second Circuit, each of the three judges rendering a separate opinion, one dissenting. (*Taft case,* R. 14–23; *Greenway case,* R. 19–28.)

Provisions similar to Section 202 (a) (2) of the 1921 Act here involved are also to be found in Section 204 (a) (2) of the Revenue Acts of 1924 and 1926, respectively, c. 234, 43 Stat. 253, 258 (U. S. C., Title 26, Sec. 935); c. 27, 44 Stat. 9, 14 (U. S. C. App., Title 26, Sec. 935). In addition, Section 204 (a) (3) of each of those Acts applies the same rule to property acquired after December 31, 1920, "by a transfer in trust."

SUMMARY OF ARGUMENT

Section 213 (b) (3) of the Revenue Act of 1921 provides that the income from property acquired by gift shall be included in gross income, and Section 202 (a) (2) provides the measure of the income from the sale of a gift. Petitioners contend that in

so far as the statute attempts to tax that part of the proceeds of the sale of a gift which represents its accumulated increase in value in the hands of the donor before acquisition by the donee, it is unconstitutional for the reason that that part represents capital to the donee at the time of acquisition by him.

The contention is based upon the premise that a gift is inherently capital. However, a gift is a transfer of property and results in clear gain to the donee. In the ordinary sense of the word and as it is used in common speech "gift" conveys the idea of income. Congress would have had no need to exempt specifically the value of a gift from gross income unless it actually was income.

If a gift is income, then it follows that Congress has power to tax the whole value or any portion of it. In the statute here involved Congress has clearly manifested its intention of taxing part of the value of a gift as income, and it is submitted that this is clearly within its power. The mere fact that Congress has imposed the tax at the time when the sale of the gift occurs should not render the tax any the less valid.

In imposing this tax it was the intention of Congress that the donee should stand in the shoes of the donor and take the gift charged with the tax which would ultimately accrue upon the gain then accumulated when later realized.

This tax may also be sustained upon the theory that it is a tax upon the income from property as distinguished from the income of the owner.

ARGUMENT

I

THE PROVISION OF SECTION 202 (A) (2) WHICH FIXES THE BASIS FOR DETERMINING THE GAIN OR LOSS IN THE CASE OF PROPERTY ACQUIRED BY GIFT IS CONSTITUTIONAL FOR THE REASON THAT IT RESULTS IN A TAX UPON INCOME AND NOT UPON CAPITAL

Although Section 213 (b) of the Revenue Act of 1921 exempts in general terms the value of property acquired by gift, Section 202 (a) (2) specifically requires the recipient of a gift in case of a sale to pay a tax upon the proceeds, such tax to be measured by the difference between the cost to the donor and the price for which sold by the donee. It is plain that there is no conflict between those two provisions. On the contrary, they are coordinated and in complete harmony. Section 213 (b) (3) provides that the income from a gift shall be taxable and Section 202 (a) (2) provides the measure for that tax in the case of the sale of the gift.

Petitioners concede that that part of the proceeds of the sale of a gift which represents the increase in the hands of the donee after acquisition is properly taxable. They contend, however, that the provision of Section 202 (a) (2) is unconstitutional in so far as it attempts to tax that part of the proceeds

of the sale of the gift which represents its accumulated increase in value in the hands of the donor before acquisition by the donee, for the reason that that part represents capital to the donee at the time of acquisition by him.

That contention is based upon the premise that a gift is in its intrinsic nature capital, but petitioners fail to establish that premise. While the question whether or not a gift is inherently capital or income has never been directly decided, the clear inference to be drawn from the manner in which gifts have been treated in various income tax laws, both Federal and State, is that they are to be regarded as inherently income. The commonly accepted meaning of the word "income" leads to the same conclusion.

In considering the meaning to be given the word "income" as used in the Sixteenth Amendment and in the Revenue Acts pursuant thereto, the courts have consistently construed the word in its ordinary sense and as it is used in common speech. Thus in *Merchants' L. & T. Co.* v. *Smietanka*, 255 U. S. 509, in construing the meaning of the word "income" as used in the Revenue Act of 1916, this Court said (p. 519):

> In determining the definition of the word "income" thus arrived at, this court has consistently refused to enter into the refinements of lexicographers or economists and has approved, in the definitions quoted, what

it believed to be the commonly understood meaning of the term which must have been in the minds of the people when they adopted the Sixteenth Amendment to the Constitution.

It would seem that in the ordinary sense of the word and as it is used in common speech, the word "gift" conveys the meaning of true income to the donee. A gift is a transfer of property and results in clear gain to the donee; there is manifestly a receipt of gain. It would certainly surprise the man in the street, for whom the tax laws are intended, to be told that if he received a gift under the circumstances of these cases he would not have made a gain nor be in receipt of income. If this gain is not income "from whatever source derived"—the language both of the Sixteenth Amendment and the Revenue Acts—then, as stated in *Irwin* v. *Gavit,* 268 U. S. 161, 166, the Revenue Act of 1921 has "missed so much of the general purpose that it expresses at the start."

We have been unable to find any judicial decision or any expression by a text writer, or any method of treatment in a taxing statute which indicates that, by reason of its intrinsic nature, a gift can not be income.

It is also a fair presumption that Congress considered a gift to be in its nature income, by reason of the fact that it deemed it necessary to specifically exempt gifts in all the Income Tax Acts from

1913 to 1926, inclusive.[1] Manifestly, if Congress had considered a gift to be in its nature capital there would have been no need for its specific exemption. It is apparent that the exemption was thought to be necessary because in its absence a gift would naturally be included in the general definition of gross income. Circuit Judge Learned Hand came to this same conclusion in announcing the decision of the Circuit Court of Appeals for the Second Circuit in the case of *Rice* v. *Eisner,* 16 F. (2d) 358, certiorari denied 273 U. S. 764, where he said (p. 360):

> The exemption in all the statutes of the corpus of gifts and bequests shows that in the minds of those who drew the acts it was thought open to question whether even this might not be considered income.

To the same effect is the dissenting opinion of Circuit Judge Ward filed in *United States* v. *Oregon-Washington R. & Nav. Co.,* 251 Fed. 211, 214:

> The Income Tax Laws of 1913, 1916, and 1917 expressly provide that only the income of gifts is to be taxed, from which it may be inferred, that but for this provision, the gifts themselves would have been taxed as income.

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[1] Revenue Act of 1913, c. 16, Sec. IIB, 38 Stat. 114, 167; Revenue Act of 1916, c. 463, Sec. 4, 39 Stat. 756, 758; Revenue Act of 1917, c. 63, Sec. 1200, 40 Stat. 300, 329; Revenue Act of 1918, c. 18, Sec. 213 (b) (3), 40 Stat. 1057, 1065; Revenue Act of 1921, c. 136, Sec. 213 (b) (3), 42 Stat. 227, 238; Revenue Act of 1924, c. 234, Sec. 213 (b) (3), 43 Stat. 253, 268; Revenue Act of 1926, c. 27, Sec. 213 (b) (3), 44 Stat. 9, 24.

But the inference is even stronger than stated in the above cases. Congress in exempting the value of gifts from gross income in the Revenue Act of 1916 specifically referred to it as income. Section 4 of that Act reads:

> SEC. 4. The following *income* shall be exempt from the provisions of this title:
> * * * the value of property acquired by gift, bequest, devise, or descent (but the income from such property shall be included as income); * * *. (Italics ours.)

Section 4 of the Revenue Act of 1916 was amended by Section 1200 of the Revenue Act of 1917, but the language of that portion now under consideration was not changed by the amendment.

It should also be noted that Section 28 of the Act of 1894, c. 349, 28 Stat. 509, specifically included as taxable income "money and the value of all personal property acquired by gift or inheritance."

The inclusion of gifts in income under that Act was not one of the grounds upon which the Act was held unconstitutional in the case of *Pollock* v. *Farmers' Loan & Trust Co.*, 157 U. S. 429, affirmed on rehearing, 158 U. S. 601.

The English law, after which it is generally known the American tax laws, both State and Federal, were in substance modeled, in the Income Tax Act of 1842 (c. 35, 5 and 6 Vict.), Section 102, levies a tax "upon all *Annuities*, yearly Interest of Money, or other annual Payments." (Italics ours.)

It is also true that the States, while they exempt gifts from taxable income, accomplish it in such a manner as to make it evident that the legislatures considered gifts to be income in fact. For example, Delaware, Missouri, Wisconsin, and Virginia specifically denominate the exemption as one of income.[2]

In Section 10 of the Act of the Virginia Assembly of 1922, c. 463, there is exempted from taxable income "The value of property acquired by gift within the year not exceeding the sum of one thousand dollars." Under this Act, therefore, the value of property acquired by gift is clearly recognized as income, although only a portion is taxable.

From the foregoing it is submitted that gifts are income in fact and that when they are exempted it is not because of anything inherent in their nature which precludes their classification as income. A gift under the circumstances of these cases is inherently a gain or profit to the donee. The fact that a gift is a part of the donor's capital does not mean that it has an unalterable capital nature and must be and remain capital to the donee.

If we are correct in our position that a gift is income in the ordinary sense of the word, then it of course follows that Congress has the power to tax either the whole value or any portion of that

[2] 32 Del. L. 20 (1921), Section 3 (a); Revised Statutes, Mo. (1919), c. 119, Art. 19, Section 13109; Wisconsin Statutes (1925), Vol. 1, Title 10, c. 71, Section 71.05 (1) (g); Va. Acts of Assembly (1922), c. 463, Section 10 (3) (h).

value as income. While Congress has apparently not deemed it expedient to tax the whole of a gift as income, as shown by the exemption, it has, on the other hand, clearly manifested its intention of taxing part of a gift as income where there has been a gain in the property transferred under the circumstances of these cases.

Because Congress has not taxed the whole gift when it was clearly all income to the donee, petitioners contend that the taxation thereafter of any greater amount than it has subsequently increased in value is unconstitutional. If it once becomes a part of the donee's property it is contended that it is his capital. It is admitted that the subsequent increase in its value after it comes into the donee's hands, is properly taxable, and yet that increase is also capital until it is released by sale. If the act of sale, to that extent, converts the increase of the gift into income when realized, why can not the same act of sale reconvert the value of a gift at the time it was received into income? If the act of sale of purchased property separates the increase from capital, and the income is the difference between the investment and the selling price, it would seem to follow logically, as a practical matter, and having due regard for the substance, that the income from the sale of a gift is the difference between the investment of the donee and the selling price. The property having cost the donee nothing, it would not be arbitrary or capricious to im-

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pose a tax upon the whole selling price. If Congress has the power to tax the whole selling price as income, there is surely nothing arbitrary in the imposition of a tax upon a portion only of that income. The difference between the price received by the donee and the original cost to the donor is none the less all income, even though it does not represent the entire gain or profit received by the donee at the time of sale.

Nor is this characterization of a gift as income inconsistent with the definition of income which this Court pronounced in *Eisner* v. *Macomber,* 252 U. S. 189. In that case the Court was interpreting the meaning of income as provided in the Revenue Act of 1916. That Act, as previously shown, specifically exempted the value of a gift from gross income. Consequently the definition of income in *Eisner* v. *Macomber* reflects that exemption.

In the *Eisner case* this Court was primarily concerned with the determination of whether or not there had been a separation of income from capital. In these cases, however, the Court is not called upon to determine whether there has been a severance of income from capital, but the sole question is whether or not the classification by Congress of a part of the value of a gift as income to the donee is beyond its power. In other words, the Court is here called upon solely to distinguish between what is and what is not in fact income in common speech and in the ordinary sense of the word. If the definition

is to be judged by those standards—and this Court in the cases cited above has held that the meaning of that word is to be so determined—there can be little doubt as to the constitutionality of the provision here under consideration.

Furthermore, it is clear that in the case of *Eisner* v. *Macomber* the Court was not necessarily prescribing the uttermost limits of the definition of the word "income." As there said with reference to the said definition (p. 207):

> Brief as it is, it indicates the characteristic and distinguishing attribute of income *essential for a correct solution of the present controversy.* (Italics ours.)

And again (p. 206):

> * * * it becomes essential to distinguish between what is and what is not "income," as the term is there used; and to apply the distinction, *as cases arise,* according to truth and substance, without regard to form. (Italics ours.)

From this it is plain that this Court recognized that *Eisner* v. *Macomber* did not establish an immutable definition but that occasion might arise in the future where it would be called upon to amplify this definition.

In this connection it should also be borne in mind that the constitutionality of a tax depends upon its practical operation and effect, and not on mere definition or theoretical distinction respecting its

nature and quality. *Shaffer* v. *Carter,* 252 U. S. 37. In that case this Court said (p. 51):

> Income taxes are a recognized method of distributing the burdens of government, favored because requiring contributions from those who realize current pecuniary benefits under the protection of the government, and because the tax may be readily proportioned to their ability to pay.

The broad scope to be given to the term "income" was also considered by this Court in *Lynch* v. *Hornby,* 247 U. S. 339, 343–344, where this Court said:

> * * * Congress was at liberty under the Amendment to tax as income, without apportionment, everything that became income, in the ordinary sense of the word, after the adoption of the Amendment * * *.

While there is no case directly in point on the question here involved, the respondent believes that the correct principles for the solution of the problem are to be found in *Lynch* v. *Hornby,* 247 U. S. 339; *Peabody* v. *Eisner,* 247 U. S. 347; *United States* v. *Phellis,* 257 U. S. 156, and *Great Northern Railway Co.* v. *Lynch,* 292 Fed. 903.

The fair market value of property on March 1, 1913, is usually recognized as capital. However, in *Lynch* v. *Hornby, supra,* when the accumulated earnings of a corporation before that date were realized thereafter as dividends to stockholders,

this Court found no difficulty in holding that such dividends constituted income to the stockholders. In that case it was said (pp. 343–344, 346):

> Corporate profits that accumulated before the act took effect stand on a different footing. As to these, however, just as we deem the legislative intent manifest to tax the stockholder with respect to such accumulations only if and when, and to the extent that, his interest in them comes to fruition as income, that is, in dividends declared, so we can perceive no constitutional obstacle that stands in the way of carrying out this intent when dividends are declared out of a preexisting surplus. The act took effect on March 1, 1913, a few days after the requisite number of States had given approval to the Sixteenth Amendment, under which for the first time Congress was empowered to tax income from property without apportioning the tax among the States according to population. *Southern Pacific Co.* v. *Lowe, supra.* That the retroactivity of the act from the date of its passage (October 3, 1913) to a date not prior to the adoption of the Amendment was permissible is settled by *Brushaber* v. *Union Pacific R. R. Co.,* 240 U. S. 1, 20. And we deem it equally clear that Congress was at liberty under the Amendment to tax as income, without apportionment, everything that became income, in the ordinary sense of the word, after the adoption of the Amendment, including dividends re-

ceived in the ordinary course by a stockholder from a corporation, even though they were extraordinary in amount and might appear upon analysis to be a mere realization in possession of an inchoate and contingent interest that the stockholder had in a surplus of corporate assets previously existing. Dividends are the appropriate fruit of stock ownership, are commonly reckoned as income, and are expended as such by the stockholder without regard to whether they are declared from the most recent earnings, or from a surplus accumulated from the earnings of the past, or are based upon the increased value of the property of the corporation. The stockholder is, in the ordinary case, a different entity from the corporation, and Congress was at liberty to treat the dividends as coming to him *ab extra*, and as constituting a part of his income when they came to hand.

Hence we construe the provision of the act that "the net income of a taxable person shall include gains, profits, and income derived from * * * interest, rent, dividends, * * * or gains or profits and income derived from any source whatever" as including (for the purposes of the additional tax) all dividends declared and paid in the ordinary course of business by a corporation to its stockholders after the taking effect of the act (March 1, 1913), whether from current earnings, or from the accumulated surplus made up of past earnings or increase in value of corporate assets, not-

withstanding it accrued to the corporation in whole or in part prior to March 1, 1913.

* * * * *

We repeat that under the 1913 Act dividends declared and paid in the ordinary course by a corporation to its stockholders after March 1, 1913, whether from current earnings or from a surplus accumulated prior to that date, were taxable as income to the stockholder.

We do not overlook the fact that every dividend distribution diminishes by just so much the assets of the corporation, and in a theoretical sense reduces the intrinsic value of the stock. But, at the same time, it demonstrates the capacity of the corporation to pay dividends, holds out a promise of further dividends in the future, and quite probably increases the market value of the shares. In our opinion, Congress laid hold of dividends paid in the ordinary course as *de facto* income of the stockholder, without regard to the ultimate effect upon the corporation resulting from their payment.

In *Peabody* v. *Eisner,* 247 U. S. 347, this Court again disregarded the March 1, 1913, value of the stock involved in that case and held the dividend received thereafter was wholly taxable, irrespective of the fact that on March 1, 1913, the capital value of the stock represented a portion of the gain which was subsequently realized as dividends.

But petitioners contend that even if a gift is income, it is only income in the year of its acquisition by the donee and that, therefore, it can not be taxed

as income of a later year. This contention, of course, is not involved with respect to the shares constituting the gift of 1922 in the *Greenway case,* for the reason that they were sold in the same year as received. To that extent, at least, if the respondent's argument as to the inherent nature of a gift is correct, there can be no question of the validity of the tax.

The respondent contends, however, that the mere fact that Congress has in its scheme of taxation fixed a later period in which to tax a gift, that is, the year in which the gain on the property involved in a gift is actually realized through conversion, does not present any difficulty or render the tax any the less valid. This is clear from the *Great Northern case, supra.* In that case, arising under the Corporation Tax Act of 1909, certain unpaid obligations of a corporation accruing prior to the year 1909, were written off the books in 1911 because outlawed by the statute of limitations. The court there held that the amount of these obligations constituted income *in the year in which written off.*

United States v. *Phellis,* 257 U. S. 156, is a clear example of the fact that accumulated gains are taxable as income when realized, despite the fact that they may appear to constitute a portion of capital. Phellis was the holder of stock in a New Jersey corporation which effected a plan of reorganization, pursuant to which a new corporation was formed in Delaware. All the assets of the New Jersey com-

pany were transferred to the Delaware company as a going concern, including the good will and a large surplus, and in part consideration the New Jersey corporation received the Delaware company's debenture stock and common stock. The latter was immediately distributed to the New Jersey company's common stockholders as a dividend. This Court held that the shares he received in the Delaware company constituted a dividend to Phellis. The opinion written by Mr. Justice Pitney contains the following pertinent language (pp. 169, 171–172):

> Claimant's capital investment was represented by his New Jersey shares. Whatever increment of value had accrued to them prior to September 30, 1915, by reason of the surplus profits that theretofore had been accumulated by the company, was still a part of claimant's capital, from which as yet he had derived no actual and therefore no taxable income so far as the surplus remained undistributed.
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> * * * * *
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> The possibility of occasional instances of apparent hardship in the incidence of the tax may be conceded. Where, as in this case, the dividend constitutes a distribution of profits accumulated during an extended period and bears a large proportion to the par value of the stock, if an investor happened to buy stock shortly before the dividend, paying a price enhanced by an estimate of the capital plus the surplus of the company, and after

distribution of the surplus, with corresponding reduction in the intrinsic and market value of the shares, he were called upon to pay a tax upon the dividend received, it might look in his case like a tax upon his capital. But it is only apparently so. In buying at a price that reflected the accumulated profits, he of course acquired as a part of the valuable rights purchased the prospect of a dividend from the accumulations—bought "dividend on," as the phrase goes—and necessarily took subject to the burden of the income tax proper to be assessed against him by reason of the dividend if and when made. He simply stepped into the shoes, in this as in other respects, of the stockholder whose shares he acquired, and presumably the prospect of a dividend influenced the price paid, and was discounted by the prospect of an income tax to be paid thereon. In short, the question whether a dividend made out of company profits constitutes income of the stockholder is not affected by antecedent transfers of the stock from hand to hand.

So in the statute here involved Congress has provided that the donee shall step into the shoes of the donor and shall receive the gift charged with the tax which would become due at that time if the property were sold and the gain realized. Congress permitted the gift to go untaxed at the time of its receipt but charged the donee with the accumulated profit, as yet unrealized; hence the donee took the

gift with notice that when that accumulated profit was thereafter realized it would be taxable income.

In this connection it is also pertinent to call attention to the fact that in *Atlantic Coast Line* v. *Daughton,* 262 U. S. 413, this Court held that a state could, consistently with the Federal Constitution, impose a tax upon the net income of property as distinguished from the net income of him who owns or operates it. While that case involves a State law, it is apparent that the principle would be no different in a case involving a Federal law.

The opinion below, of Circuit Judge Learned Hand, reflects the same thought. He says (*Taft case,* R. 21; *Greenway case,* R. 26):

> I am not concerned for the moment with whose gain it is, but that the whole gain is income can not, I submit, be disputed. If it is important, I suggest that the language of the Amendment itself gives Congress power to lay "taxes on incomes," not on persons. Therefore there is a subject-matter which Congress may tax without apportionment, and part of which, after *Eisner* v. *Macomber,* it could not tax in any other way, except perhaps as an excise.

As this Court said in *LaBelle Iron Works* v. *United States,* 256 U. S. 377, 392:

> The difficulty of adjusting any system of taxation so as to render it precisely equal in its bearing is proverbial, and such nicety is not even required of the States under the equal-protection clause, much less of Con-

gress under the more general requirement of due process of law in taxation. Of course it will be understood that Congress has very ample authority to adjust its income taxes according to its discretion, within the bounds of geographical uniformity. Courts have no authority to pass upon the propriety of its measures; and we deal with the present criticism only for the purpose of refuting the contention, strongly urged, that the tax is so wholly arbitrary as to amount to confiscation.

This position of the respondent finds support in the opinion of Judge Manton in the court below (*Taft case*, R. 17; *Greenway case*, R. 22):

> The obvious purpose of section 202 (a) (2) was to prevent the loss of income represented within the profit to the donor during the period he held the property before he made his gift. Congress has determined that this same increment shall be recognized as income, even though a gift intervenes. The transfer by gift is but a change of ownership in the specific property. In doing this, Congress imposes no tax upon an unrealized gain. The value of the property is ignored or not taken into account until the property is finally disposed of in such a way that it could be determined that the owner made either a gain or a loss, and, until there is a sale, there is no necessity for measuring income, nor is there an opportunity to do so. This avoids tax evasion or tax avoidance. This statute puts the donee, who pays nothing for the property, and who therefore loses nothing, on

any theory of economic principle, in the position the donor would have been, in so far as taxation is concerned.

The need for the statute is disclosed by the report of the Senate Committee on Finance upon the Revenue bill of 1921 (Report No. 275, 67th Congress, 1st Session, pp. 10–11):

> An essential change, however, is made in the case of property acquired by gift. No explicit rule is found in the present statute for determining gain or loss resulting from the sale of such property, but the Treasury Department has held that the proper basis for such determination is the fair market price or value of such property at the time of its acquisition by the donee. This rule has been the source of serious abuse. Taxpayers who have property the value of which has increased, give such property to wives or relatives, by whom it may be sold without taxation of the increase in value which took place while the property was owned by the donor. The proposed bill, in paragraph (2) of subdivision (a), provides a new and just rule, namely, that in the case of property acquired by gift after December 31, 1920, the basis for computing gain or loss is the same as that which it would have in the hands of the donor or the last preceding owner by whom it was not acquired by gift. This means that if the property cost the donor $50, and at the time it was given to the donee it was worth $100, for which

> amount it is sold by the donee, the income of the donee would be $50 instead of nothing, as under the present law. If the facts necessary to determine the cost are unknown to the donee, the commissioner is empowered to obtain the facts from the donor or any other person, or, if it is found impossible to obtain such facts, to appraise the value of such property as of the time it was acquired by such donor or last preceding owner. This paragraph does not apply to gifts made in contemplation of death or to gifts made to take effect in possession and enjoyment at or after death, but such testimentary gifts are to be treated as bequests or devises.

The report of the Ways and Means Committee of the House of Representatives contains a similar statement. (Report No. 350, 67th Congress, 1st Session, p. 9.)

It is submitted that the above discussion and authorities lead to the conclusion that gifts are income in the ordinary sense of the word. That Congress and the State legislatures so regard them is apparent from the treatment accorded them in the Revenue Acts, certain Acts taxing them as income, and others, while recognizing gifts as income, nevertheless exempting them from taxable income. If they are income, it results that Congress is at liberty under the Sixteenth Amendment to levy a tax without apportionment upon their value and by the same authority to tax a portion only of their value and at the same time postpone the tax until the

time of sale. So far as the 1922 gift in the *Greenway case* is concerned, since it was sold in the same year it was received it would seem to require no extended discussion to sustain the validity of the tax as applied to it.

Not only does a gift seem to meet the concept of income but, on the other hand, it does not seem to meet the concept of capital in so far as capital has been defined. The commonly advanced theory depicts capital as a reservoir supplied from springs. *Eisner* v. *Macomber, supra,* p. 206. And the definition has been presented that capital is anything, material or otherwise, capable of ownership, viewed in its static condition at a moment of time, or the rights of ownership therein. *Lynch* v. *Turrish,* 247 U. S. 221, 227.

It is plain that the gift during the act of transfer to the donee is not in a static condition. It is then in flux and can not be capital until it comes to rest in the reservoir of the donee.

It is accordingly submitted that the statute is constitutional. However, in view of the contrary contention which is being pressed upon the Court, respondent calls attention to two cardinal principles of construction which are applicable to this case.

This Court has often recognized that a measure may be valid as a necessary adjunct to a matter that lies within legislative power, even though, standing alone, its constitutionality might have been subject to doubt. *Purity Extract Co.* v. *Lynch,*

226 U. S. 192; *Ruppert* v. *Caffey,* 251 U. S. 264, 289; *Everard's Breweries* v. *Day,* 265 U. S. 545, 560.

If this statute falls, the definition of income as laid down by this Court will lose one of its important concepts, namely, that the definition must be held to "include profit gained through a sale or conversion of capital assets." If increment upon the sale of a capital asset is income and the same increment is not income when a gift intervenes, the number of cases of intervention will be many. Therefore, in support of this statute respondent relies upon the broad ground that it is a necessary part of an entire taxing scheme which is deemed necessary to satisfy the need of the Government for revenue.

Respondent further relies upon the presumption, repeatedly indulged, in favor of the validity of an Act of Congress. *Nicol* v. *Ames,* 173 U. S. 509; *United States* v. *Berwind-White Coal Mining Co.,* 274 U. S. 564; *Hampton, Jr., & Co.* v. *United States,* No. 242, October Term, 1927, decided April 9, 1928. And the presumption should be particularly strong where the objection to an Act arises, not from a specific limitation or prohibition on congressional power, but only out of the "vague contours of the Fifth Amendment, prohibiting the depriving any person of liberty or property without due process of law." *Adkins* v. *Children's Hospital,* 261 U. S. 525, 568.

II

THE AUTHORITIES RELIED UPON BY PETITIONER ARE DISTINGUISHABLE OR NOT INCONSISTENT WITH THE POSITION OF RESPONDENT

Petitioner strongly relies upon the decision of the Circuit Court of Appeals for the Second Circuit in the case of *United States* v. *Oregon-Washington R. & Nav. Co.*, 251 Fed. 211. The Oregon Short Line Company owned all the stock of the Oregon-Washington Railway & Navigation Company, to which the former had also advanced a considerable sum of money. In a rearrangement of these book items the Short Line Company released its debt against the Oregon-Washington Railway & Navigation Company to the approximate amount of six million dollars. This release the Government treated as part of the income of the Oregon-Washington Railway & Navigation Company for that year. The court held that the transaction did not result in income for the reason that since the Short Line Company owned all the stock of the Oregon-Washington Railway & Navigation Company and also the debt, the release of the debt was a means of contribution to the capital of the Oregon-Washington Railway & Navigation Company quite as though the money had been contributed by the stockholder to enhance the value of his stock.

It is clear, however, that a cancellation of indebtedness is not always a contribution to capital, as is shown by the instance cited in the *Oregon-Washington case* of a cancellation of bond coupons. The decision in the *Great Northern case, supra,* is another instance. Therefore, the *Oregon-Washington case* is no authority for the contention that a cancellation of indebtedness is inherently a contribution to capital.

Nor does *Edwards* v. *Cuba Railroad,* 268 U. S. 628, support petitioners' contention that the value of a gift is capital. The opinion in that case did not rest upon that premise. In fact, this Court did not even regard the subsidies there involved as true gifts. With respect to that point this Court said (p. 632):

> Such aids, gifts and grants from the government, subordinate political subdivisions or private sources,—whether of land, other property, credit or money,—in order to induce construction and operation of railroads for the service of the public are not given as mere gratuities.

While this case is authority for the contention that a subsidy is a contribution to capital, the decision distinguishes subsidies from gifts and is no authority for the proposition that a gift is inherently capital.

The decision in *Lynch* v. *Turrish,* 247 U. S. 221, rested upon the finding that there was a mere change in the form of property, without any in-

crease in value. Therefore that case is not helpful in determining the proper method of measuring gains.

Neither can petitioners find any support for their contention in the recent decision of this Court in the case of *Heiner* v. *Tindle,* No. 341, October Term, 1927, decided April 9, 1928. The question here involved was not an issue in that case and no argument with regard to the nature of a gift or the basis adopted in the Revenue Act of 1921 for measuring gain upon the sale of a gift was presented to the Court. The discussion in the opinion regarding gifts was merely by way of illustration and was not the ground of the decision. Furthermore, the Court was considering the Revenue Act of 1918, and quite evidently had in mind the provisions of that Act and the regulations issued thereunder. There is nothing in the language of that opinion which in any manner touches the new basis adopted in the Revenue Act of 1921 for measuring the gain or loss upon the sale of a gift.

Petitioners' brief is predicated upon the theory that a gift is capital to the donee, but the cases cited do not support that contention. They are simply to the effect that the capital investment must first be deducted from the gross proceeds of sale before there can be a determination of gain. The respondent's position is not in conflict with those cases for the reason that, as pointed out above, the capital investment of a donee in the case of a gift is zero.

CONCLUSION

A gift is clear gain to the donee and its value is true income. It is apparent that since Congress has exempted the value of gifts from taxable income the Government is put to the narrow choice of taxing the donee for the gain or nobody at all. It is evident that the method adopted results in reaching only what is clearly a gain accruing to property which was the subject of the gift, and it is submitted that under such circumstances an arbitrary or capricious character can not be ascribed to the tax. Having exempted the value of the gift from taxation when received, it is difficult to give assent to a contention which requires the finding that the tax imposed upon a lesser portion of that value when realized is so wholly arbitrary as to amount to confiscation.

It is respectfully submitted that the judgments below should be affirmed.

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APRIL, 1928.

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